Exhibit 33

Law of Guarantees

SIXTH EDITION

By

Geraldine Mary Andrews, QC
LLB, LLM (King's College London) of
Gray's Inn and Lincoln's Inn, Barrister

Richard Millett, QC
BA (Trinity Hall, Cambridge) of
Lincoln's Inn, Barrister

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Foreword

Debt default is serious. It brought the world financial system to the brink of collapse in 2009 and, as this book goes to press, the risk of debt default threatens the world economy once again. No wonder then that creditors try to protect themselves against that risk. One way of doing so is by taking guarantees. Like so many legal terms the word "guarantee" is used in many different senses, and is often used to describe obligations that are not really guarantees at all. That is why care is needed in understanding what rights and obligations any particular contract creates. This edition of Andrews and Millett's well-known and authoritative work explains clearly and comprehensively the many different forms of contract; and who can sue whom and for what.

The authors' thoughtful discussion of electronic communications and signatures also demonstrates that it is no longer adequate to define a surety as "a fool with a pen."

The reader will find all the up to date authorities discussed and dissected. The recent pronouncement of the Court of Appeal on authorised guarantee agreements and guarantees of authorised guarantee agreement is fully covered, thus for the time being bringing an end to what aficionados call the AGA saga and the GAGA saga.

The international character of commerce is well-reflected in the book; not only in its discussion of where to sue and what legal system governs the contract, but also in their use of authorities from far afield. Where they disagree with decisions of the courts, even at the highest level, they are not afraid to say so forthrightly. Neither the House of Lords nor the High Court of Australia escape. Their prescient criticism of the decision of the majority of the Court of Appeal in *Rainy Sky v Kookmin Bank* has very recently been vindicated by the Supreme Court's reversal of the Court of Appeal. Their dislike of judicial approaches to conclusive evidence clauses is cogently argued, and in that regard they subject at least one of my own decisions to critical scrutiny. If they do not like the outcome of judicial decisions they offer practical advice for circumventing or minimising the consequences. Where the law is doubtful (and it often is) they suggest ways in which it might develop.

It is difficult to imagine a more thorough treatment of the Law of Guarantees. I welcome this latest edition.

Kim Lewison
Royal Courts of Justice
London WC2A 2LL

Foreword to 5th Edition

By The Rt. Hon. Lord Neuberger of Abbotsbury

There are two particular requirements for conscientious solicitors, barristers, and other professionals, who are seeking to ensure they are in a position to advise commercial clients accurately and fully. The first is to be sure that they are thoroughly *au fait* with all modern developments in the area of law in which they are advising. The second requirement is to be sure that they have a full and balanced view of that area of law. In other words, they have to be aware of every tree in the relevant wood, but they must also see the wood and assess it in a balanced way.

These requirements have always been particularly acute in relation to the law of guarantees. It is not merely that guarantees are a topic where the commercial world and the legal world meet. Guarantees are subject to a large quantity of both old and new judge-made law, and they span many other areas of law (e.g. insolvency, landlord and tenant, banking, husband and wife, to take just a few examples). Further, the law of guarantees is liable to develop in accordance with fairly swiftly moving commercial changes, it is a topic on which many different jurisdictions learn from each other, and it is one which often leads to emotionally charged and difficult litigation.

With the significant increase in the volume of both judicial decisions and statutes regulations and the like, in this country and elsewhere, the two requirements I have mentioned have become increasingly difficult to satisfy. The position has been substantially exacerbated by the very substantial increase in the proportion of decided cases and other material which are available electronically. Since I ceased practice eleven years ago, life has got much harder, or to use a current euphemism, much more challenging, for those in legal practice as a result of the ever increasing quantity of available electronic information.

It is these factors which make a reliable, up-to-date, and authoritative text book on the law of guarantees so valuable, indeed indispensable, to a lawyer or other professional who has to advise on, or argue about, any issue in the field. The fifth edition of Geraldine Andrews's and Richard Millett's work on *The Law of Guarantees* is such a text book. Its substantial size indicates the thoroughness of the authors and the fullness of their treatment of the law. Comparison with the size of the first edition shows the extent to which the law in this area has developed over the past 15 years. Many lawyers (including me) have consulted, and benefited from, the earlier editions, and this will no doubt be every bit as true of this edition.

The current edition rightly recognises the developments and changes in the law that have occurred since the publication of the fourth edition. In particular, I would draw attention to the new section in Chapter 4, dealing with the effectiveness of clauses permitting variation of the underlying contract, the re-writing of Chapter 17, following the introduction of the Consumer Credit Act 2006, and the discussion of significant new cases, especially in the fields of insolvency and of landlord and tenant. It is not merely changes in the law that are faced up to; Chapter 3 contains a new discussion of the operation of section 4 of the Statute of Frauds 1677 in the electronic age.

As Lord Justice Jacob wrote when introducing the fourth edition, despite their busy practices at the Commercial Bar, the two authors have somehow managed to find time to prepare a properly reconsidered, overhauled, and up-to-date book on the law of guarantees. The legal profession and other interested groups should be grateful to them.

Lord Neuberger of Abbotsbury
November 2007

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Chapter 1

Definitions and Characteristics

Suretyship

Suretyship is the generic term given to contracts by which one person (the surety) agrees to answer for some existing or future liability of another (the principal) to a third person (the creditor), and by which the surety's liability is in addition to, and not in substitution for, that of the principal. In most cases, the contract will involve the assumption by the surety of personal liability to the creditor. However, it may also consist of the provision by the surety of a pledge or security in support of the performance of the principal's obligation, for example, a charge on property.[1] **1–001**

Rights of a surety

The obligations of a surety are usually created expressly by contract, but it is unnecessary for a person to contract as guarantor in order to acquire the rights of a surety. A person who, on the face of a contract, appears to be under a primary obligation to the creditor, may nevertheless acquire the rights of a surety by giving him notice. For example: **1–002**

> D and S enter into a contract with C under which they undertake to be jointly liable for the repayment of money advanced by C to D. Subsequently, D and S agree as between themselves that D is to assume the primary responsibility for repayment of C, and S is to be secondarily liable. Once notice of this arrangement has been given to C, he is bound to respect S's position as a surety, even if he does not assent to the modification of the original arrangement and even if, by this time, the debt has fallen due for repayment. This will not prevent C from suing S (rather than D) for the debt but he must respect S's rights as surety, for example, by preserving his rights to other securities.[2]

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[1] *Smith v Wood* [1929] 1 Ch 14, *Re Conley* [1938] 2 All E.R. 127; and *Deutsche Bank v Ibrahim* [1992] 1 Bank. L.R. 267.

[2] *Rouse v Bradford Banking Co Ltd* [1894] A.C. 586. This case finally decided that the assent of the creditor to a modification of the original position was unnecessary and that, in accordance with the approach taken by the courts of equity, notice was sufficient.

In certain cases, where there is a primary and secondary liability of two persons for the same debt, they will stand in the relationship to each other of principal and surety even though there is no express contract of suretyship between them.[3] Thus the acceptor of an accommodation bill of exchange is a surety for the payment by the drawer, and the maker of an accommodation note is in the position of a surety, with all the surety's rights.[4] However, the relationship of principal and surety will not always arise in such circumstances. For instance, if property which was subject to a mortgage has been sold and the mortgagor remains under a liability to the mortgagee, he does not become a surety for the purchaser: *Re Errington* [1894] 1 Q.B. 11. Similarly, if a person assigns a lease and the assignee covenants to indemnify him against liability for breaches of covenants in the lease, the assignee thereby undertakes a primary liability as between himself and the assignor, but the assignor does not become a surety for the assignee.[5] A transferor of shares does not become the guarantor of the transferee, though he may be liable by statute to pay calls if the transferee does not.[6]

Contracts of suretyship

1-003 Contracts of suretyship fall into two main categories: contracts of guarantee and contracts of indemnity. Guarantees and indemnities have many similar characteristics, and similar rights and duties arise between the parties. Consequently, it is not unusual to find the term "guarantee" used loosely to describe a contract which is in reality an indemnity (and vice versa). However, despite the similarities, it is often important to ascertain into which of these two categories a particular agreement falls. This can have a significant bearing on the enforceability of the contract against the surety, and the extent and nature of his liability, in two particular respects.

First, contracts of guarantee, but not contracts of indemnity, are prima facie unenforceable by the creditor if they do not comply with the requirements of s.4 of the Statute of Frauds 1677.[7] Secondly, the liability of a guarantor is normally co-extensive with the liability of the principal. Therefore, if the obligation of the principal to the creditor is unenforceable, or has been discharged, the liability of the surety may depend on whether the contract is a guarantee or an indemnity.[8]

In addition to guarantees and indemnities, there are various types of commercial contract, such as performance bonds (sometimes called "performance guarantees"), export credit guarantees and carnets, which may be described as contracts of suretyship, or which are very closely related to them, and yet have special distinct characteristics which it is more appropriate to consider independently.

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[3] See *Duncan Fox & Co v North and South Wales Bank* (1880–81) L.R. 6 App. Cas. 1 at 11, discussed in para.1–006.

[4] See, e.g. *Re Acraman, Ex parte Webster* (1847) De G. 414; *Bailey v Edwards* (1864) 4 B. & S. 761; *Yonge, Ex parte* (1814) 3 V. & B. 31 at 40, per Lord Eldon L.C.

[5] *Baynton v Morgan* (1888) L.R. 21 Q.B.D. 101, see also *Allied London Investments Ltd v Hambro Life Assurance Plc* (1984) 269 E.G. 41; *Selous Street Properties v Oronel Fabrics* (1984) 270 E.G. 743.

[6] See *Gore-Browne on Companies*, Vol.2, Ch.23, para 8; *Roberts v Crowe* (1872) L.R. 7 C.P. 629; *Contract Corp* (1871) L.R. 12 Eq. 1; *Helbert v Banner* (1871) L.R. 5 H.L. 28.

[7] See Ch.3.

[8] See Chs 6 and 9.

These will therefore be dealt with in detail in Chs 14 to 16 of this book. Chapter 18 will deal with the special considerations which may apply to contracts of guarantee in the context of the relationships between landlord and tenant and their respective assignees.

Contracts of guarantee

Definition

A contract of guarantee, in the true sense, is a contract whereby the surety (or guarantor) promises the creditor to be responsible, in addition to the principal, for the due performance by the principal of his existing or future obligations to the creditor, if the principal fails to perform those obligations. In *Wardens and Commonalty of the Mystery of Mercers of the City of London v New Hampshire Insurance Company* (1991) 3 J.I.B.F.L. 144, Phillips J. cited with approval the following definition of a guarantee which is given in *Halsbury's Laws of England* (5th edn, 2008), para.1013. 1–004

> "A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promisee for the debt, default or miscarriage of another person,[9] whose primary liability to the promisee must exist or be contemplated."[10]

In *Vossloh AG v Alpha Trains (UK) Ltd* [2010] EWHC 2443 (Ch), [2011] 2 All E.R. (Comm) 307, Sir William Blackburne gave the following succinct definition at [23]:

> "A contract of guarantee, in the true sense, is a contract whereby the surety (the guarantor) promises the creditor to be responsible for the due performance by the principal of his existing or future obligations to the creditor if the principal fails to perform them or any of them."

Although the expressions "creditor" and "debtor" are often used to denote the underlying obligee and obligor, the liability which is guaranteed may consist of performance of some obligation other than the payment of a debt, and does not have to be a contractual liability, although it usually is.

The liability of the guarantor has been defined as a liability not only to perform himself if the principal fails to do so, but to procure (or "see to it") that the principal performs his obligations.[11] However, given that in practice the guarantor is rarely in a position to compel the principal to perform his obligations, it is probably more accurate to describe the guarantor's promise as a promise that the obli-

[9] The words "debt, default or miscarriage" are taken from the Statute of Frauds (1677) s.4, see Ch.3.
[10] For a list of other definitions of guarantee that have been given in textbooks and treatises from time to time, see *Re Conley* [1938] 2 All E.R. 127 at 130–131.
[11] *Moschi v Lep Air Services Ltd* [1973] A.C. 331 especially per Lord Diplock at 348–349. Cf *General Produce Co v United Bank* [1979] 2 Lloyd's Rep. 255, where Lloyd L.J. at 258 refers to two classes of guarantee: a promise which becomes effective if the debtor fails to perform his obligations; and a promise that the debtor will perform his obligations.

gation will be performed, in the sense that the guarantor will be personally liable for the debt, default or miscarriage of the principal. This analysis has been preferred in Australia: in *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 C.L.R. 245, Mason C J. went so far as to describe Lord Diplock's definition of the nature of the guarantor's obligation as "fictitious and quite unrealistic". Therefore, even if the guarantor has not in terms guaranteed the payment of damages to the creditor, he will normally be liable in damages to the same extent as the principal for breach of the latter's obligations.[12]

The description of the guarantor's obligation as a promise to answer for the principal's default (or see to it that his obligations are performed) may well be apposite for the majority of guarantees, but it does not prevent a contract of guarantee from providing on its true construction that the guarantor will pay a sum of money to the creditor upon default by the principal, in which case his liability will sound in debt rather than in damages. The nature of the promise made by the guarantor in such a case is "if the principal does not pay the sum that he owes you on the due date, I will pay it." In *Vossloh AG v Alpha Trains (UK) Ltd* (above) at [23], Sir William Blackburne explained the distinction thus:

> "Depending on its true construction, the obligation undertaken by the surety may be no more than to discharge a liability, for example a particular debt, if the principal does not discharge it, so that if for any reason the principal ceases to be liable to pay that debt (it may have been discharged and replaced by some other debt or liability) the surety will not come under any liability to the creditor. The surety's liability in such a case is conditional upon the principal's failure to pay the particular debt so that if the condition is fulfilled the surety's liability will sound in debt. In contrast to that is the more usual case (sometimes referred to as a 'see to it' guarantee) where, on the true construction of the contract, the surety undertakes that the principal will carry out his contract and will answer for his default. In such a case, if for any reason the principal fails to act as required by his contract he not only breaks his own contract, but he also puts the surety in breach of his contract with the creditor, thereby entitling the creditor to sue the surety, not for the unpaid debt, but for damages. The damages are for the loss suffered by the creditor due to the principal having failed to do what the surety undertook that he would do. See Moschi v Lep Air Services Ltd [1973] AC 331 at 344 to 345 (Lord Reid)."

However, a contract which on its true construction gives rise to an *independent* personal liability, on the part of the surety, to pay a sum of money to the creditor on default by the principal will be an indemnity, not a guarantee. There is a danger of the distinction between the two types of contract becoming blurred, in consequence of judges straining to characterise the guarantor's obligation as sounding in debt in order to avoid what may be perceived as unfair or uncommercial results. In *Hampton v Minns* [2002] 1 W.L.R. 1, a contract which not only contained a

[12] *Moschi v Lep Air Services*, [1973] AC 331, *Quest 4 Finance Ltd v Maxfield* [2007] EWHC 2313 (QB), and see further paras 6–002 and 7–018.

guarantee of "the payment or discharge ... of all monies and liabilities which shall be for the time being be due owing or incurred by the Principal to you" but also an express undertaking that the undersigned would on demand discharge those moneys and liabilities, was construed as giving rise to an obligation in debt. A similar approach was taken by Briggs J. in *McGuinness v Peterborough BS* [2011] 1 W.L.R. 613. For a more detailed consideration of those cases, see Ch.6, para.6-002 and Ch.7, para 7-018.

Essential characteristics

Secondary liability

1-005 The essential distinguishing feature of a contract of guarantee is that the liability of the guarantor is always ancillary, or secondary, to that of the principal, who remains primarily liable to the creditor.[13] There is no liability on the guarantor unless and until the principal has failed to perform his obligations.[14] In *Lakeman v Mountstephen* (1874) L.R. 7 H.L. 17, Lord Selborne put the matter succinctly at 24:

> "There can be no suretyship unless there be a principal debtor, who of course may be constituted in the course of the transaction by matters ex post facto and need not be so at the time, but until there is a principal debtor there can be no suretyship. Nor can a man guarantee anybody else's debt unless there is a debt of some other person to be guaranteed."[15]

It follows from the secondary nature of the obligation, that the guarantor is generally only liable to the same extent that the principal is liable to the creditor, and that there is usually no liability on the part of the guarantor if the underlying obligation is void or unenforceable, or if that obligation ceases to exist. This is known as "the principle of co-extensiveness". There are, however, a number of established exceptions to the principle of co-extensiveness under which the guarantor may find himself liable to the creditor, notwithstanding the unenforceability of the principal obligation.[16]

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[13] A surety's obligation is secondary where the agreement leaves another person primarily liable for the performance of that obligation: see, e.g. *Mallet v Bateman* (1865) L.R. 1 C.P. 163 (Ex Ch); *Harburg India Rubber Comb Co v Martin* [1902] 1 K.B. 778 at 784; *Fahey v MSD Spiers Ltd* [1973] 2 N.Z.L.R. 655; *Clipper Maritime Ltd v Shirlstar Container Transport Ltd (The Anemone)* [1987] 1 Lloyd's Rep. 546 at 555. In *Clement v Clement* (1996) 71 P&CRD. 19 (CA) CAT No. 1336 of 1995, October 20, (discussed in para.1-013) Peter Gibson L.J. said (at p.7 of the transcript): "The crucial question is whether by the actual words used, the obligation undertaken is dependent on the continued existence of the liability of [the principal] ..." For a good example of the distinction between a primary obligation and a secondary obligation, see *Birkmeyr v Darnell* (1704) 1 Salk 27, 91 E.R. 27.

[14] Thus, a contract of guarantee has been described as a contract to indemnify the creditor on the occurrence of a contingency, namely the default of the principal debtor: see *Sampson, Assignees of Cook, a Bankrupt v Burton* (1820) 4 Moore C.P. 515, 129 E.R. 891.

[15] See also the observations of Donaldson J. in *General Surety & Guarantee Co Ltd v Francis Parker Ltd* (1977) 6 B.L.R. 16 at 21 and Sir William Blackburne in *Vossloh AG v Alpha Trains (UK) Ltd* [2010] EWHC 2443 (Ch), [2011] 2 All E.R. (Comm) 307 at [24].

[16] See further Ch.6.

A contract under which the liability of the principal debtor is extinguished or replaced by the liability of some other person cannot be a contract of guarantee. In *Re International Life Assurance Society and Hercules Insurance Co Ex p. Blood* (1870) L.R. 9 Eq. 316, the holder of a policy of life assurance was informed that the insurer had been dissolved, and had transferred its business and assets to the H Company. He was offered either a new policy or an indorsement of the old policy by the H Company "guaranteeing its due fulfilment". He opted for the latter. It was held by the Vice-Chancellor that the indorsement constituted a novation and not a contract of guarantee, as it was obvious from the context of the transaction that there was no intention that the original insurer should remain liable on the policy.

See also the decision of the Court of Appeal in *Meritz Fire & Marine Insurance Co Ltd v Jan de Nul NV* [2011] EWCA Civ 827. The buyers of dredgers being built by a Korean shipyard known as HWS were obliged to make advance payments of the price of the vessels to HWS, but obtained an "advance payment guarantee" (APG) from insurers, Meritz, which provided that, in the event of premature termination of the shipbuilding contract for certain specified reasons, the advance payments would be returned with interest. HWS subsequently agreed to merge with another Korean company to form a new company, B. Under Korean law, Meritz had the opportunity to protest about the merger and the transfer of the shipbuilding contracts to B, but they did not do so. A few months later, B's board resolved to partition its shipbuilding business from its other activities and transferred it to a newly incorporated entity, A. Under Korean law, on merger, B succeeded to all the rights and obligations of HWS, and A succeeded to the rights and obligations of B under the shipbuilding contracts. The buyers terminated the shipbuilding contracts for delay and claimed repayment of the price from A. When A did not pay, the buyers sought payment under the APG. They served a signed statement in conformity with the terms of the APG certifying that their demand for refund was made "in conformity with cl.17 of the Contract and that the Builder has failed to make the refund." The main issue for the court was whether there was a novation which discharged Meritz from their obligations under the APG. It was held by Beatson J. and the Court of Appeal that the APG was not a guarantee but a performance bond,[17] and that on its true construction it was intended to operate on the basis that no refund had occurred, and not on the basis that HWG had failed to make the refunds when it was obliged to do so. Accordingly, Meritz was liable to pay.

Creditor must be a party

1-006 It is essential that the creditor should be a party to a contract of guarantee, because he is the person to whom the guarantor makes the promise to be answerable for the debt, default or miscarriage of the principal. Any contract of suretyship to which the creditor is not a party must be a contract of indemnity.

Thus, in *Duncan Fox & Co v North & South Wales Bank* (1880–81) L.R. 6 App. Cas. 1 at 11, Lord Selborne identified three specific types of contract of suretyship:

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[17] See 1-015 and Ch.16.

(1) those in which there is an agreement to constitute, for a particular purpose, the relation of principal and surety, to which agreement the creditor thereby secured is a party;

(2) those in which there is a similar agreement between the principal and surety only, to which the creditor is a stranger;

(3) those in which, without any such contract of suretyship, there is a primary and secondary liability of two persons for one and the same debt, the debt being, as between the two, that of one of those persons only, and not equally of both, so that the other, if he should be compelled to pay it, would be entitled to reimbursement from the person by whom (as between the two) it ought to have been paid.

Of these types, only the first category would embrace a true contract of guarantee, the others are illustrations of contracts of indemnity between surety and principal alone. In such cases, the creditor is entitled to treat the surety as a principal. However, as already stated, once the creditor has been given notice of the agreement, he is bound to give effect to the rights of the surety against him and against any co-sureties.[18]

So, for example, if A and B are jointly indebted to C, and A and B agree between themselves that B shall act as surety only, C will retain the right to recover the debt from B as a principal debtor, because he is not a party to the agreement, even if he has notice of it.[19] However, once C has notice of the agreement between A and B, he will be bound to do nothing to prejudice the rights of the surety, B, in his dealings with other securities, or by agreeing to a material variation in C's contract with A (such as giving A more time to pay, without B's assent).[20]

This rule, which is of equitable origin, applies equally whether the agreement between A and B is made before or after they become indebted to C.

However, where the guarantee is embodied in a deed and the creditor is not a party to the deed, the creditor will be entitled to enforce the guarantee if it is plain as a matter of construction of the deed that he was intended to be the beneficiary of the promises made by the surety in the deed: see, e.g. *Moody v Condor Insurance Ltd* [2006] 1 W.L.R. 1847 (discussed in Ch.2, para.2-021). In such a case, the contract is one of guarantee and not indemnity. The creditor, though not a signatory to the deed, is still a party to the guarantee agreement made by the surety which is evidenced by the deed. This is so even if, as in *Moody v Condor Insurance Ltd*, the deed superficially appears to relate to an agreement between the principal and surety only.

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[18] *Duncan Fox & Co v North & South Wales Bank* (1880–81) L.R. 6 App. Cas. 1 at 12; *Rouse v Bradford Banking Co* [1894] A.C. 586; *Oriental Finance Corporation v Overend, Gurney & Co* (1871) 7 Ch. App. 142, affd L.R. 7 H.L. 348 at 361.

[19] *Duncan Fox & Co v North and South Wales Bank* (1880–81) 6 L.R. App. Cas. 1 at 11–12, per Lord Selborne; *Nicholas v Ridley* [1904] 1 Ch.192. See also *Esso Petroleum Co Ltd v Alstonbridge Properties Ltd* [1975] 1 W.L.R. 1474.

[20] *Overend Gurney & Co Ltd (Liquidators) v Oriental Financial Corp Ltd (Liquidators)* [1871] L.R. 7 Ch. App. 142, affd L.R. 7 H.L. 348; *Rouse v Bradford Banking Co* [1894] A.C. 586 per Lord Watson at 598; *Goldfarb v Bartlett & Kremer (A Firm)* [1920] 1 K.B. 639 at 647–648.

Writing and signature

1–007 A third distinguishing characteristic of a contract of guarantee is that, unlike a contract of indemnity, the essential elements of the agreement are required by s.4 of the Statute of Frauds 1677 to be made or recorded in writing and signed by the guarantor or by someone with his authority. This is because the statute applies to contracts under which the surety assumes a secondary rather than a primary liability.

However, not all guarantees fall within the ambit of the Statute of Frauds 1677. Further, the absence of a written agreement or memorandum is not necessarily fatal to the enforcement of a guarantee, and does not affect the underlying validity of the contract.[21] Therefore, although the need for writing is often described as an essential characteristic of a guarantee, it is more accurate to describe it as a normal prerequisite to enforcement.

Guarantees and insurance

1–008 Contracts of insurance and contracts of guarantee are both examples of contracts which protect the creditor from loss. However, the scope of a contract of guarantee is narrower than the potential scope of a contract of insurance, which may protect the insured against contingencies other than the non-performance by another person of obligations or duties owed to the insured. A contract of insurance is a contract whereby the insurer agrees, in consideration of the payment to him of a premium, to pay a specified sum to the insured on the occurrence of a specified event.[22] His liability does not depend on the existence of a principal, or even on default; for example, the contract may provide for payment simply in the event that the principal does not pay (albeit that he may be justified in withholding payment). An underwriter is not a surety. He is under a primary obligation to make payment, not a collateral liability to answer for the obligations of the principal. He will normally have no influence at all over the principal's performance of those obligations. Consequently, an event which might discharge a surety will not discharge the insurer from his liability.[23]

One context in which this distinction may prove to be of some importance is where an insurance company provides a mortgage protection policy to the creditor by way of additional security for a loan secured by a mortgage. The premium for such a policy is often paid by the mortgagor. The answer to the question whether the contract with the insurance company is a contract of guarantee or a contract of insurance could, in certain circumstances, have a significant effect on the rights and obligations of the issuer of the policy, the creditor and the mortgagor or other sureties. The following two cases illustrate the type of difficulties which can arise.

In *Re Denton's Estate* [1904] 2 Ch. 178, the late Mr Denton was a party to a joint and several covenant with the mortgagor in which he agreed to pay on

[21] See further Ch.3.

[22] See *Prudential Insurance Co v Inland Revenue Commissioners* [1904] 2 K.B. 658 at 663, per Channell J.

[23] See, e.g. *Dane v Mortgage Insurance Corp Ltd* [1894] 1 Q.B. 54; *Finlay v Mexican Investment Corp* [1897] 1 Q.B. 517

demand the principal and the interest subject to a limit of £1,000. The deed expressly provided that although as between Mr Denton and the mortgagor he was to be regarded as a surety only, as between Mr Denton and the bank, he was to be considered a principal debtor for the whole mortgage debt. The bank had effected a "mortgage insurance policy" with the plaintiff. In due course the mortgagor defaulted, the plaintiff paid under the policy and sued Mr Denton's estate. It was argued that the "policy" was not one of insurance, but of guarantee, and that the plaintiffs stood in the position of co-sureties with Mr Denton and therefore had to contribute to the loss. The Court of Appeal held (Vaughan Williams L.J. expressing considerable hesitation) that despite the form of the "policy" being that of a policy of insurance, in substance it was a guarantee. However, since the guarantee extended to covering Mr Denton's own obligations to the bank as well as those of the mortgagor, there was no right of contribution.[24]

In *Woolwich Building Society v Brown* [1996] C.L.C. 625, the mortgagor claimed that the creditor, a building society, was obliged to give credit, in computing its claim against him, for money received by it under what was described as an "indemnity guarantee" issued by an insurance company (the premiums for which were paid by the mortgagor). Under the terms of the contract, the insurers were liable to pay a sum which was calculated not by reference to what the mortgagor owed, but by reference to a formula, on the occurrence of three specific events:

(1) the building society exercising its right of sale of the mortgaged house;

(2) the mortgagor failing to make any payment;

(3) the proceeds of sale being less than the outstanding debt.

In the light of these factors, Waller J. held that the contract was a contract of insurance and that, accordingly, the insurers were entitled to pursue their subrogated claim in the name of the building society for the full indebtedness, without giving credit for the sum which they had paid. He also expressed the view that even if the contract had been a guarantee, the same result would have been reached.

Sometimes it will be just as easy for the creditor to insure against the default of the principal as it will be for him to obtain a guarantee, and the premium may be a comparatively small price to pay for the relative security of insurance provided by a large commercial institution. On the other hand, the creditor may prefer to dictate the precise terms of the contract which protects him against the anticipated loss, and he may be in such a strong bargaining position with the principal that he can require and obtain the protection of a guarantee without having to make any payment.

The fact that the doctrine of utmost good faith applies to all contracts of insurance may be another matter which the creditor will take into consideration. Contracts of guarantee are not generally subject to this doctrine, although there is a limited duty of disclosure.[25] However, a contract of guarantee may be expressed

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[24] Applying *Craythorne v Swinburne* (1807) 4 Ves. 160, and see generally Chs 11 and 12.

[25] *North Shore Ventures Ltd v Anstead Holdings Inc* [2011] EWCA Civ 230, and the line of authorities referred to therein, see further Ch.5, paras 5-015–5-027

in the form of a contract of insurance.[26] It has been said that many contracts may be described by either term, and that the question whether a contract is one of the utmost good faith depends on its true character: see *Seaton v Heath* [1899] 1 Q.B. 782 at 792, per Romer L.J.[27] Accordingly, the question whether the doctrine of the utmost good faith applies may turn on the true construction of the contract and there is no reason why the duty of disclosure of material facts should not be expressly incorporated into a contract of guarantee. Certain types of export credit guarantee have this feature.[28]

Types of guarantee

1–009 There is a considerable variety in the types of guarantee into which parties may enter. They may be very specific, relating to a particular defined obligation of the principal and to no other obligation, or very widely drawn, covering any present and future obligations of the principal to the creditor, whatsoever and howsoever arising. Similarly, the guarantee may be for a limited period or completely open ended. Some of the different types of guarantee are identified below.

Bipartite and tripartite guarantees

The simplest form of guarantee is the one in which the creditor, principal and surety are all parties to the contract and all three agree that the principal is to be primarily liable and that the guarantor's liability is secondary. However, although the creditor is an essential party to a contract of guarantee, it is by no means unusual for the contract to be made between the guarantor and the creditor alone.

For example, the surety may be induced to give the guarantee by some person other than the principal (e.g. the principal's spouse) and may not enter into any contractual relationship with the principal.[29] The contract may also be entered into at the express or implied request of the surety, as when a person who purchases goods manufactured by the principal persuades the creditor to supply the principal with raw materials on advantageous credit terms, by offering him a guarantee of the indebtedness which arises on the underlying trading account. In such a situation, the principal need not even know of the arrangements made between the creditor and the guarantor, though he usually would be aware of them.

Continuing and limited guarantees

1–010 Although it is common for a guarantee to be limited in duration, a guarantee may also be entered into for an indefinite period. A continuing guarantee is one which extends to a series of transactions, whether or not over a limited period. Guarantees of overdraft facilities afforded by a bank to a trading company are often both continuing and of unlimited duration, though it is common in such contracts to include a provision enabling the guarantor to give a specific period of notice to the creditor to determine his future liability. If there is no express period of notice,

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[26] See, e.g. *Re Denton's Estate* [1904] 2 Ch. 178, above.
[27] Revised without affecting this point [1900] A.C. 135.
[28] See Ch.15.
[29] See, e.g. *Brown Shipley & Co Ltd v Amalgamated Investment (Europe) BV* [1979] 1 Lloyd's Rep. 488 (guarantee of a loan to a subsidiary at the request of the parent company).

the question whether the guarantor can terminate his liability (in the absence of a repudiation by the creditor, or frustrating event) will depend on the construction of the particular contract and on the nature of the principal debtor's underlying obligation.[30]

A guarantee may in terms refer only to the obligations arising under an identified contract or even to a specific obligation, for example the obligation to pay the purchase price under a particular contract of sale. At the other extreme, the guarantee may cover "liability in respect of any loss, damage, claims, costs, charges and expenses (including interest) and any other liability whatsoever and howsoever arising" which the principal may incur to the creditor.

Guarantees payable on demand

A guarantee may contain an express stipulation that the surety is to be liable to make payment to the creditor "on demand".[31] In such event, the obligation of the guarantor to pay does not arise until the demand has been made on him, though his underlying liability arises at the date of the principal's default. The demand will usually be construed as a procedural requirement included for the guarantor's protection, which he may waive, rather than as a condition precedent to liability, which he may not. The demand marks the time from which the surety's liability can be enforced, see *Stimpson v Smith* [1999] 2 W.L.R. 1292 at 1304, per Tuckey L.J. 1-011

The fact that the obligation of the principal is to pay on demand will not automatically mean that the creditor is obliged to make a demand on the surety as well. The guarantee may contain an express provision requiring such a demand to be made on the principal before a demand is made on the surety; it may also contain a provision requiring the creditor to give the surety notice of default by the principal before he takes proceedings against the surety.[32] It is more common, however, for a modern guarantee to contain a provision expressly negating any obligation on the part of the creditor to make a demand on the principal, to notify the surety of his default, or to take any other step before enforcing the guarantee. Indeed, even a guarantee obliging the surety to make a payment "on demand" may be construed as not requiring the creditor to make a demand on the surety before instituting proceedings against him, if there is clause entitling the creditor to treat him as a principal debtor or primary obligor.[33] Whilst a demand will often be made an express prerequisite to bringing a claim under a normal guarantee, the expression "demand guarantee" is apt to cause confusion, because in certain contexts it is synonymous with a performance bond (see para.1-015 and Ch.16). For example, that is the meaning which the expression bears under the *ICC Uniform Rules for Demand Guarantees* (ICC publication No.758), and its predecessor (ICC publication No.458) discussed in Ch.16.

[30] See Ch.8.
[31] See, e.g. *Romain and Wolfson v Scuba TV Ltd* [1997] Q.B. 887; *Sicklemore v Thistleton* (1817) 6 M. & S. 9; *Bradford Old Bank v Sutcliffe* [1918] 2 K.B. 833, *Re Brown's Estate* [1893] 2 Ch 300; *General Financial Corporation of Canada v Le Jeune* [1918] 1 W.W.R. 372 (Can).
[32] *Bache & Co (London) Ltd v Banque Vernes et Commerciale de Paris SA* [1973] 2 Lloyd's Rep. 437; *Phillips v Fordyce* (1779) 2 Chit. 676, see also *Banthrone v Paterson* (1898) 35 Sc. L.R. 344; *Britannia Steamship Insurance Association Ltd v Duff* [1909] S.C. 1261 (Scot).
[33] See paras 1-014 and 7-006

Contracts of indemnity

Definition

1–012 An indemnity, in its widest sense, comprises an obligation imposed by operation of law or by contract on one person to make good a loss suffered by another. Thus most contracts of insurance and all contracts of guarantee fall within the broad definition. However, the expression "contract of indemnity" is more often used to denote a contract where the person giving the indemnity does so by way of security for the performance of an obligation by another. It is this type of contract with which this book is concerned.

Essential characteristics

1–013 In a contract of indemnity, unlike a contract of guarantee, a primary liability falls upon the surety, and that liability is wholly independent of any liability which may arise as between the principal and the creditor (unless the indemnifier undertakes a joint liability with the principal). Of course, it is usually implicit in such an arrangement that as between the principal and the surety, the principal is to be primarily liable, so that if the surety has to pay first, he has a right of recourse against the principal.[34] Indeed when two parties are primarily liable to the creditor they may enter into an express agreement that, as between themselves, one is to be treated as surety. For an example of a case in which it was held that there was no such right of recourse in the absence of an express agreement, see *Berghoff Trading v Swinbrook Developments* [2009] 2 Lloyd's Rep. 233, discussed in Ch.10, para.10–006.

The fact that the obligation to indemnify is primary and independent has the effect that the principle of co-extensiveness and the requirements of s.4 of the Statute of Frauds 1677 do not apply to contracts of indemnity. Thus an indemnity not only effectively shifts the burden of the principal's insolvency onto the surety, but also potentially safeguards the creditor against the possibility that his underlying transaction with the principal is void or otherwise unenforceable.[35] Further, the discharge of the principal or any variation or compromise of the creditor's claims against him will not necessarily affect the liability of the surety under a contract of indemnity.[36] Otherwise, the rights and duties of the parties to a contract of indemnity are generally the same as those of the parties to a contract of guarantee.

The question whether a particular contract happens to be a guarantee or an indemnity, and whether the normal incidents of a contract of that class have been modified, is a matter of construction in each case, and is often very difficult to

[34] See *Chitty on Contracts*, 30th edn. (London: Sweet & Maxwell, 2008), Vol.2, para.44–003, approved by Rix L.J. in *Berghoff Trading Ltd v Swinbrook Developments Ltd* [2009] 2 Lloyd's Rep. 233 at [25]; *Vossloh AG v Alpha Trains (UK) Ltd* [2010] EWHC 2443 (Ch), [2011] 2 All E.R. (Comm) 307, at [25].

[35] See, e.g. *Yeoman Credit v Latter* [1961] 1 W.L.R. 828; *Goulston Discount Co v Clark* [1967] 2 Q.B. 493. Cf. *Bentworth v Lubert* [1968] 1 Q.B. 680; *Vossloh AG v Alpha Trains (UK) Ltd* (above), at [26].

[36] See Ch.6.

resolve. A contract of suretyship which contains a provision preserving liability in circumstances in which a guarantor would otherwise be discharged (such as the granting of time to the principal or a material variation of the underlying contract without the surety's consent) will usually be construed as a guarantee, because such a provision would be unnecessary if the contract was an indemnity.

The contract may also contain a provision to the effect that the surety is to be liable in circumstances in which the principal debtor has ceased to be liable, e.g. on the release of the principal debtor by the creditor. Although it may be argued, by parity of reasoning, that this tends to indicate that the contract is a guarantee, such a provision may point towards the opposite conclusion because it may show that it was intended that the liability of the obligor should continue regardless of what might happen to the principal debtor. A good illustration of this is to be found in the Court of Appeal case of *Clement v Clement* (CAT No.1336 of 1995, October 20), (1996) 71 P&CR (D) 10.

A dispute between a husband, his wife and their son about the running of a family-owned company was settled on terms that the parents sold their shares and retired from the company. In return the company agreed that it would pay the father a pension during his lifetime and, if he died before his wife, the company would pay her a reduced pension from the date of his death for the rest of her life. Both pensions were index linked. The son sent his parents a letter in the following terms:

> "By an agreement of even date ('the Agreement') between First Fashions Ltd ('the Company') and yourselves the Company covenanted to pay certain retirement benefits. Now I undertake that if the Company . . . fail(s) to pay the sums covenanted to be paid by it I or my personal representatives will pay such sums or so much of them as shall not be paid. This guarantee shall continue in force until the death of the survivor of you . . ."

The Company subsequently went into voluntary liquidation and the liquidator disclaimed the pension contract. On the law as it then stood, it was believed that the disclaimer determined both the liability of the Company and the liability of any guarantor.[37] The son therefore sought to argue that the letter was a guarantee. Warner J. and the Court of Appeal held that despite the fact that the letter described itself as a "guarantee" it was an indemnity. On the true construction of the contract, the obligation to pay the pension until the death of the surviving parent arose regardless of what might happen in the meantime to the Company or to its liabilities. It did not depend on the continued existence of the liability of the Company.

If the contract provides that the surety is to be liable in circumstances in which the principal debtor was never liable (e.g. because the principal debtor lacked the capacity to contract), it may indicate that the contract is an indemnity.[38] A contract which provides for the surety to be liable in circumstances in which the principal debtor has rescinded or avoided the underlying contract may prove exceptionally

[37] Following *Stacey v Hill* [1901] 1 Q.B. 660, which was subsequently overruled by the House of Lords in *Hindcastle Ltd v Barbara Attenborough Associates Ltd* [1997] A.C. 70, see Ch.18.

[38] See, e.g. *Alliance Acceptance Co v Hinton* [1964] 1 D.C.R. (NSW) 5.

difficult to classify. Indeed, it is possible that a clause which purports to preserve the guarantor's liability in the event that the underlying transaction is void or avoided will be ineffective, because the guarantee as a whole never comes into effect: this could occur, for example, if the consideration for the guarantee is expressed to be the entry into the principal contract.

"Principal debtor" clauses

1–014 It is common for standard form bank guarantees and similar documents to contain a provision that the surety is to be liable "as principal debtor" or that the creditor may treat him as a principal debtor or "primary obligor" in certain circumstances. A provision of this kind is typically found at the end of a clause which expressly preserves the guarantor's liability in circumstances in which he would otherwise be released. An example is the clause in *National Westminster Bank v Riley* [1986] B.C.L.C. 268 which provided that "this guarantee shall not be discharged nor shall the Guarantor's liability under it be affected by anything which would not have discharged or affected the Guarantor's liability if the Guarantor had been a principal debtor to the Bank instead of a Guarantor". The Court of Appeal held that this precluded the guarantor from raising an argument by way of defence that he had been discharged from liability by virtue of a fundamental breach of the contract with the borrower by the bank. However, even as a self-standing provision it may be construed as having that effect: see, e.g. *Heald v O'Connor* [1971] 1 W.L.R. 497.[39] The prevailing view appears to be that the incorporation of a "principal debtor" clause will not usually suffice in itself to determine the nature of the contract: it will not automatically convert a guarantee into an indemnity.[40] In *MS Fashions Ltd v Bank of Credit and Commerce International A (In Liquidation)* [1993] Ch. 425, Dillon L.J. explained that the purpose of including such a clause in a guarantee is to dispense with the requirement of a demand on the surety as a prerequisite to taking steps to enforce the guarantee against him.[41]

Similarly, the contract may include a separate provision by which the surety contracts in terms to indemnify the creditor against loss or damage suffered by him arising out of, or consequential upon, his having entered into the agreement with the principal. The question whether this provision will affect the nature of the contract as a whole, or whether it will give rise to independent obligations, is one of construction. If the obligation to indemnify is couched in terms which make it

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[39] See also *Fletcher Organisation Pty Ltd v Crocus Investments Pty Ltd* [1988] Qd. R. 517; *Orme v DeBoyette* [1981] 1 N.Z.L.R. 576, but cf. *Dunlop New Zealand Ltd v Dumbleton* [1968] N.Z.L.R. 1092 and *Payton v SG Brookes & Sons Pty Ltd* [1977] W.A.R. 91.

[40] This statement was cited with approval by Blair J. in *Carey Value Added SL (formerly Losan Hotels World Value Added I SL) v Grupo Urvasco SA* [2010] EWHC 1905, [2011] 2 All E.R. (Comm) 140 at [22]; see also, to like effect, J. O'Donovan and J. Phillips, *The Modern Contract of Guarantee*, 2nd edn (London: Sweet & Maxwell, 2010), para.1–104. See further *Heald v O'Connor* [1971] 1 W.L.R. 497, per Fisher J. at 503; *General Produce Co v United Bank* [1979] 2 Lloyd's Rep. 255 per Lloyd J. at 259; *Brown Brothers Motor Lease Canada Ltd v Ganapahi* (1982) 139 D.L.R. (3d) 227; *Credit Suisse v Borough Council of Allerdale* [1995] 1 Lloyd's Rep. 315 per Colman J. at 366–367; *Habibullah Hohamed Yousef v Indian Bank* [1999] 3 SLR 650; *P.T. Jaya Sumpiles Indonesia v Kristle Trading* [2009] 1 SLR. 945 at [52]–[57].

[41] See further *TS&S Global Ltd v Fithian-Franks* [2007] EWHC 1401 (Ch) [2008] 1 B.C.L.C. 277 and the discussion in para.7–006.

plain that it is predicated upon there being an underlying liability of the principal, the contract will remain a guarantee. This may explain the decision of the Court of Appeal in *Stadium Finance Co v Helm* (1965) 109 S.J. 471 to the effect that a contract was a guarantee, notwithstanding that it was headed "indemnity form" and containing the following term:

> "I will indemnify and keep indemnified you, your successors and assigns from all loss and damage suffered and all claims costs and expenses made against or incurred by you in any way arising out of or consequent upon your having entered into such agreement, whether arising out of a breach by the customer of any of the terms and conditions thereof or otherwise including any such loss or damage etc. aforesaid as may arise from the said agreement being (for whatever reason) unenforceable against the customer."

A more common approach, if the language of the contract permits it, is to treat the contract as giving rise to separate enforceable obligations of indemnity and guarantee: see, e.g. the Australian case of *Citicorp Australia Ltd v Hendry* [1985] 4 N.S.W.L.R. 1 where the contract was treated as a guarantee which contained an additional liability under the indemnity clause. However, the language of the indemnity clause is all-important; in that particular case the indemnity provision did not preserve the liability of the guarantor when the sums payable under the principal contract were irrecoverable by the creditor because they were in the nature of a penalty.

A more recent example of a guarantee containing separate indemnity obligations is to be found in *Vossloh AG v Alpha Trains (UK) Ltd* [2010] EWHC 2443 (Ch); [2011] 2 All E.R. (Comm) 307 (discussed in detail in para.1–015) where the clause setting out the obligations of the surety, cl.2, contained various sub-clauses, some of which were couched in the language of secondary obligation and some in the language of primary obligation. The definitions section specified that references to obligations "guaranteed" were to include a reference to indemnified obligations. Although the opening words of cl.2 referred to "the Guarantor hereby unconditionally and irrevocably as a continuing obligation and as principal debtor and not merely as surety, as a separate continuing and primary obligation" performing the various obligations set out in the following sub-clauses, the judge, Sir William Blackburne, held that in context those words were ineffective to convert into purely primary obligations, obligations which were otherwise secondary in nature. The opening words were more consistent with an intention to set out in what followed a mixture of primary and secondary obligations, and the sub-clauses that followed showed all the signs of an intention to subject the surety to an obligation to answer for every kind of default that could arise under, or in connection with, what was referred to in the definition of "Secured Obligations" as a "Relevant Document". The possibility of overlap and duplication did not matter provided that all possibilities were covered. If the issue in the case had been whether the contract was an indemnity or a guarantee, it appears from this analysis that the judge would have found it was the latter.

Indemnity provisions in a standard guarantee form range from, at one end of the scale, a clause which requires the surety to indemnify the creditor in respect of costs

and other expenses incurred by him in consequence of the principal's default, even if they are irrecoverable from the principal, to, at the other end of the scale, clauses which appear to overlap with the guarantee obligation completely. The latter type of clause may result in the guarantee aspects of the contract being redundant, since the creditor is almost invariably going to be better off enforcing the primary obligations undertaken in an indemnity. An example is the contract in *Sofaer v Anglo Irish Asset Finance Plc* [2011] EWHC 1480 (Ch), which contained a clause entitled "guarantee and indemnity". The "guarantee" in cl.2.1, provided that:

> "[T]he Guarantor (a) guarantees the payment and the discharge of the Liabilities and (b) undertakes on demand to pay to the Lender any Liability which is not paid and to perform any Liability which is not performed when due to be paid or performed."

The "indemnity" in cl.2.2 provided that as an obligation independent of [the guarantee]:

> "[T]he Guarantor . . . agrees to indemnify each Beneficiary on demand against any loss suffered by each Beneficiary as a result of the Unenforceability of any Liability as against the Borrowers and/or any Liability not being discharged or performed by the Borrowers."

The Clause went on to state that the amount of the loss, where the Liability arises from the payment obligations, was the amount payable by the Borrowers or which would be so payable but for the unenforceability of that Liability and in any other case the amount which is payable to the Lender by the Borrowers by way of damages for breach of that Liability or would be so payable but for the unenforceability of that Liability, in each case together with the cost to the Beneficiary of procuring or attempting to procure the performance of such Liability.

Lewison J. held that cl.2.1(b) and the whole of cl.2.2 were contracts of indemnity, undertaken by the surety as a primary obligor and not in a secondary capacity by virtue of a separate provision to that effect in cl.2.4. In consequence, his obligations under those provisions sounded in debt and the lender was entitled to issue bankruptcy proceedings against him without first obtaining a judgment.[42] Whilst the finding in relation to cl.2.1(b) is open to debate, as the obligations of the surety were still clearly premised upon a default by the principal, there can be no such doubt about the nature of cl.2.2. That clause was so wide in its ambit that there was probably no need for cl.2.1 to have been included in the agreement.

Performance bonds

1–015 Bonds are simple covenants by one person to pay another, either conditionally or unconditionally. A performance bond, also commonly called a "performance

[42] Following *McGuinness v Norwich and Peterborough BS* [2010] EWHC 2989. See further the discussion in Ch.6–002 of the circumstances in which a guarantor's liability sounds in debt rather than in damages.

not have been made to the creditor, i.e. to the firm as a whole, because a man cannot make a promise to himself and others, and the case is therefore often cited as an example falling within this exception. However, the reasoning of Bowen L.J. is at least questionable, and it may be that a court faced with the same issue nowadays would find a different route to reach the conclusion that the agreement was an indemnity.

Promises made to third parties

3–010 A promise made to someone who is not a party to the contract between the principal and the creditor, that the principal will perform the contract, is not within s.4; *Hargreaves v Parsons* (1844) 13 M. & W. 561. So, for example, an oral promise made by a charterer to the shipowner's agent at the port of discharge that if the shipowner does not pay the agent's fees, the charterer will, is an indemnity and not a guarantee. Similarly, a promise made by S to a bailiff executing judgment that S will pay the amount of the judgment debt owed by D, in consideration of the bailiff forbearing to proceed with execution, is outside the Statute of Frauds.[25]

Novation

3–011 An agreement under which the creditor agrees to release the principal from liability in substitution for a new agreement under which either the principal and the surety are both liable (jointly or severally) or under which the surety alone is liable, is not within s.4 of the Statute of Frauds. In such circumstances the surety is not agreeing to be liable for the debt of another because that debt has been released; instead he is undertaking a fresh, independent liability of his own.[26]

The release of the principal may be, and often is, effected by his discharge from execution of a judgment debt.[27] However the release or discharge must be absolute, unconditional and effective. If the creditor simply agrees to forbear to sue the principal, or makes an agreement to release the principal with the surety alone, it is possible that the principal's underlying liability has not been replaced by the arrangements with the surety and the promise by the surety might then amount to a promise to pay the debts of another.[28]

Joint liabilities

3–012 If the surety agrees with the creditor to become jointly liable with the principal (whether or not there is a release of the original debt) then he is undertaking a personal liability rather than a liability to answer for the debt of another and his promise falls outside the scope of s.4.[29] That position is unaffected by whatever

[25] *Reader v Kingham* (1862) 13 C.B. N.S. 344; see also *Love's case* (1706) 1 Salk. 28 and *Cripps v Hartnoll* (1863) 4 B. & S. 414.

[26] See, e.g. *Browning, Assignees of Morgan, a Bankrupt v Stallard* (1814) 5 Taunt. 450; *Goodman v Chase* (1818) 1 B. & Ald. 297; *Re London and London Ex p. Lane* (1846) De G. 300; *Commercial Bank of Tasmania v Jones* [1893] A.C. 313. Cf. *Meritz Fire & Marine Insurance Co Ltd. v Jan De Nul NV* [2011] EWCA Civ 827 where the contract was held to be an indemnity operating regardless of the novation of the underlying obligations on merger of the principal obligor.

[27] *Goodman v Chase* (1818) 1 B. & Ald. 297; *Bird v Gammon* (1837) 3 Bing. N.C. 883, *Lane v Burghart* (1841) 1 Q.B. 933; *Butcher v George Drummond Steuart* (1843) 11 M. & W. 857

[28] See, e.g. *King v Wilson* (1875) 2 Stra. 873; *Fish v Hutchinson* (1759) 2 Wils. K.B. 94.

[29] See, e.g. *Thomas v Cook* (1828) 8 B. & C. 728; *Wildes v Dudlow* (1874) L.R. 19 Eq. 198.

private arrangements the principal and surety may have entered into, e.g. if they agree that as between themselves the principal is to be primarily liable. An example illustrates this:

A is a small manufacturer of garments made from natural fibres coloured with organic dyes. A enters into a joint venture arrangement with B, a large retail company which will use its chain of shops to sell the garments. In order to promote the products A and B approach C, an advertising agency. A cannot afford to finance suitably glossy advertisements. A and B enter into an oral contract with C whereby they agree jointly to pay C for the advertisements. However, they agree between themselves that B will pay C, and A will reimburse B out of the profits of the joint venture. The agreement between A, B and C is one under which A and B are each under an original liability to C and the Statute of Frauds need not be complied with.

Lack of co-extensiveness

If the liability of the surety is greater than that of the principal, the contract is an indemnity and falls outside s.4. So, for example, an agreement in which S agrees to indemnify C against "any loss you might suffer by reason of the fact that D for any reason does not repay the loan . . ." is not a guarantee because S's liability is not necessarily the same as D's. Thus, recourse agreements taken by hire purchase companies from a car dealer providing for payment by the car dealer in the event of the default of the hirer would normally be outside the Statute of Frauds even if they were made orally. The finance company may not be able to recover the full hire-purchase price from the defaulting hirer, but the dealer would normally be liable under the recourse agreement to pay for all losses, and his liability would therefore be different and independent from the hirer's.[30] 3–013

Similarly, if the surety agrees to pay regardless of whether the principal is liable, or in circumstances in which there is considerable doubt as to the principal's liability, he is not undertaking to pay in respect of the "debt, default or miscarriage of another". Accordingly, if it is clear from the nature of the contract that it was entered into specifically to safeguard against the possibility that the principal would not be liable to the creditor, the contract does not fall within the statute: *Lakeman v Mountstephen* (1874) L.R. 7 H.L. 17.

Incidental guarantees

Even if the promise by the surety is plainly a promise to answer for the debt default or miscarriage of another, the contract will not fall within s.4 of the Statute of Frauds unless the main or immediate object of the contract is to secure the payment of the debt or the fulfilment of a duty by another person: *Harburg India Rubber Comb Co Ltd v Martin* [1902] 1 K.B. 778.[31] The rule was summarised by Vaughan Williams L.J. in that case at 786: 3–014

[30] See, e.g. *Goulston Discount Co v Clark* [1967] 2 Q.B. 493; *Yeoman Credit Ltd v Latter* [1961] 1 W.L.R. 828. See also Consumer Credit Act 1974, s.113(7) as amended by the Minors Contracts Act 1987, s.4(1).

[31] And see the cases cited in *Halsbury's Laws*, (5th edn, 2008), Vol.49, para.1061, fn.4.

The creditor may pursue the surety first

7–009 Just as there is generally no requirement to make a demand on the principal before proceeding against the surety, there is no obligation on the part of the creditor to commence proceedings against the principal, whether criminal or civil, or to commence arbitration against him, unless there is an express term in the contract requiring him to do so, or his cause of action does not arise until he obtains a judgment or arbitral award, e.g. if the guarantee is confined to payment of a sum awarded by the arbitrators.[36] Likewise, there is no rule that the creditor must avail himself of other securities which the debtor may have given himself or sue a co-surety, before looking to the surety for payment, unless the contract states that he must do so, or he is obliged to do so by a relevant statutory provision.[37] In general terms the creditor has a completely unfettered choice as to how, and against whom, he should proceed to recover the debt or damages to which he is entitled. The creditor may simultaneously bring winding-up proceedings against the principal and sue on the guarantee in separate proceedings: *Permanent Custodians Ltd v Digital Enterprises Pty Ltd* (1992) 8 A.C.S.R. 542.

Thus, in the absence of any condition precedent in the contract, all that the creditor needs to establish to complete his cause of action against the guarantor is that the principal has defaulted: for example, that the last day for repayment of a loan has passed by without payment, or that the principal has committed a relevant breach of contract. Whether or not a default has occurred will depend on the nature of the contract and the circumstances of each particular case.[38]

The general rule that the creditor may proceed directly against the surety has been endorsed by the House of Lords. In *Moschi v Lep Air Services Ltd* [1973] A.C. 331 at 356, Lord Simon cited with approval a passage from *Rowlatt on the Law of Principal and Surety* which formulated the rule thus:

> "On default of the principal promisor causing damage to the promisee the surety is, apart from special stipulation, immediately liable to the full extent of his obligation, without being entitled to require either notice of the default, or previous recourse against the principal, or simultaneous recourse against co-sureties."

Lord Simon observed that the rule had not been questioned in the course of argument in the case then under consideration. He also approved the reason given by Rowlatt for the rule, which is that it is the obligation of the guarantor, rather than

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[36] *Wright v Simpson* (1802) 6 Ves. Jr. 714; *Barber v Mackrell* (1892) 68 L.T. 29; *Lawrence v Walmsley* (1862) 12 C.B.N.S. 799; *Lee v Bayes and Robinson* (1856) 18 C.B. 599; *Palmer v Sheridan-Vickers, The Times*, July 20, 1910; *Bank of Nova Scotia v Vancouver Associated Contractors* Ltd [1954] 3 D.L.R. 72; *Themistocles Navegacion SA v Langton ("The Queen Frederica")* [1978] 2 Lloyd's Rep. 164. See further Ch.11, paras 11–002–11–004.

[37] See the discussion in Ch.11. See also *Wilks v Heeley* (1832) 1 Cr. & M. 249; *Gwynne v Burnell* (1840) 6 Bing. N.C. 453, reversing (1835) 2 Bing. N.C. 7, sub nom. *Collins v Gwynne*. Unless he can exercise his right in equity to have the securities marshalled (as to which, see Ch.11, para.11–015) the surety has no right to those securities until after he has paid the debt himself: *Re Howe Ex p. Brett* (1871) L.R. 6 Ch. App. 838 at 841. For an example of an express obligation see *Musket v Rogers* (1839) 8 Scott 51.

[38] For an example of the difficulties which may arise, see the cases discussed in *Rowlatt on the Law of Principal and Surety* (5th edn, 1999), pp.110–111 and in O'Donovan and Phillips, *The Modern Contract of Guarantee* (2nd English edn, 2010) at paras 10–147–10–151.

Chapter 9

Discharge of the Surety

Discharge of surety by discharge of the principal

Since the purpose of a guarantee is to secure the performance of the principal's obligations towards the creditor, the surety will be discharged from his liability under the guarantee if the principal pays the debt or performs the obligation which the surety has guaranteed, or if the principal's liability is forgiven. This is an aspect of the principle of co-extensiveness of liability, discussed elsewhere in this work.[1] The position is different where the contract is on its true construction one of indemnity, under which the surety assumes an independent liability from that of the principal which may often be greater in scope. Accordingly he may not necessarily be discharged by reason of the performance by the principal of his obligations, or otherwise by his discharge.[2] **9–001**

Discharge by payment or performance

Payment or performance by the principal

Payment of the principal debt by the principal will discharge the surety. In *Western Credit v Alberry* [1964] 1 W.L.R. 945, where a surety guaranteed due performance by a hirer (the principal) of his obligations under a hire-purchase contract, the surety was held to be discharged where the hirer had terminated the hire purchase contract in accordance with its terms and had paid the full amount due under the contract, even though the creditor did not receive the full amounts that it was entitled to receive had the hire-purchase contract run to expiry. This case can be contrasted with *Goulston Discount Co v Clark* [1967] 2 Q.B. 493, where the facts were similar to those in the *Western Credit* case, but because the contract was one **9–002**

[1] See Ch.6, para 6–002. In *Canadian Permanent Trust Co v King Art Developments Ltd* [1984] 4 W.W.R. 587, CA, Laycraft J.A. stated, at 643–634: "Prima facie a guarantor's obligations are co-extensive with the principal debtor but the starting point must always be to analyse the nature of the guarantor's undertaking. Depending upon the terms of the guarantor's contract with the debtor, his obligation may persist even though the creditor is temporarily or even permanently disabled from pursuing the debtor to collect the debt. It is also important to an analysis of the problem to remember that although the obligations of the surety and the principal debtor are often co-extensive they are, nevertheless, separate and distinct obligations. Though co-extensiveness of the obligations of the debtor and the surety may be varied by the surety's contract with the creditor, I have difficulty in envisioning the contractual term which would hold a surety liable when the debt guaranteed has been paid. The essence of suretyship contracts is to see that the obligations between debtor and creditor are satisfied."

[2] *Goulston Discount Co Ltd v Clark* [1967] 2 Q.B. 493; cf. *Bentworth Finance v Lubert* [1968] 1 Q.B. 680. But now see Consumer Credit Act 1974, s.113.

surety, but to whether there was the potential for prejudice (see 116). The Court of Appeal firmly rejected the introduction into English law of a flexible rule based on the actual significance and effect of any particular alteration.[121]

Sometimes the physical nature of the alteration is relevant. In *Cooperative Bank Plc v Tipper* [1996] 4 All E.R. 366, Judge Roger Cooke had to consider the effect of the alteration, by the creditor bank, of the names of the sureties. The guarantee had erroneously described the sureties as "the customer" (i.e. the borrower) and as the sureties. The guarantee was altered in pencil by the bank, following execution, to delete the reference to "customer". The borrower went into liquidation and the bank claimed rectification of the guarantee in order to enforce it. The sureties claimed that, rectification or no rectification, they had been discharged by the alteration. The judge held that since the alteration had been made in pencil, the most natural inference was that it was not intended to be a final and operative alteration: it was "deliberative", and not "final and absolute" as would have been the case if it were in pen (ink or biro). Had it been in ink, the judge held that the alteration would most certainly have been material.[122]

Material variation of the terms

The rule in Holme v Brunskill

9–023 Any material variation of the terms of the principal contract (i.e. between the creditor and the principal) will discharge the surety. This is known as the rule in *Holme v Brunskill* (1878) L.R. 3 Q.B.D. 495. The facts of the case were that the creditor let a farm with sheep on it to the principal, the surety guaranteeing the redelivery of the flock in good condition at the end of the term. During the course of the term the agreement was varied between the creditor and the principal whereby the principal surrendered one of the fields up to the creditor in return for a reduction in rent of £10, without the knowledge or assent of the surety. The Court of Appeal held (Brett L.J. dissenting) that even though the variation made no substantial difference to the tenancy agreement, the surety was discharged from liability. Cotton L.J. said (at 505):

> "The true rule in my opinion is that if there is any agreement between the principals with reference to the contract guaranteed, the surety ought to be consulted, and if he has not consented to the alteration, although in cases where it is without enquiry evident that the alteration is unsubstantial, or that it cannot otherwise be beneficial to the surety, the surety may not be discharged; yet that if it is not self-evident that the alteration is unsubstantial,

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[121] As expressed in Canada in *CIBC v Skender* [1986] 1 W.W.R. 284, per Lambert J.A. at 288; though cf the current approach in Canada set out in McGuinness, *The Law of Guarantees* (2nd edn, 1996) at 10.12 - 10.13, which is in line with the approach of the CA in *Raiffeisen Zentralbank Osterreich v Crosseas Shipping Ltd*. The rejection of a flexible result-based test was justified on the grounds that the rule in *Pigot's Case* is designed to avoid fraud, and should be rigorously applied. It is to be contrasted with the approach of the English court to the application of the test of materiality to the avoidance of insurance contracts on the grounds of breach of the duty of utmost good faith, following *Pan Atlantic Insurance Co v Pine Top Insurance Co* [1995] 1 A.C. 501, which introduced a requirement of reliance.

[122] His view was obiter, and in any event would be unlikely to withstand scrutiny after *Raiffeisen Zentralbank Osterreich v Crosseas Shipping Ltd* [2000] 1 W.L.R. 1135.

> or one which cannot be prejudicial to the surety, the Court . . . will hold that in such a case the surety himself must be the sole judge whether or not he will consent to remain liable notwithstanding the alteration, and that if he has not so consented he will be discharged."

Therefore in general terms the surety is entitled to require that his position shall not be altered by any agreement between the creditor and the principal from that in which he stood at the time of his contract.[123]

Materiality

A variation of the principal contract is material for the purposes of the rule in *Holme v Brunskill* where it is not necessarily beneficial to the surety or otherwise prejudices him, and where any lack of prejudice or benefit is not evident without enquiry.[124] If the benefit or lack of prejudice is not self-evident, then the court will not embark on an enquiry as to whether the variation was indeed beneficial to the surety or otherwise unprejudicial.[125] **9–024**

In *Ankhar Pty Ltd v National Westminster Finance (Australia) Ltd* (1987) 162 C.L.R. 549 (at 559) the High Court of Australia formulated the rule as follows:

> "According to the English cases, the principle applies so as to discharge the surety when conduct on the part of the creditor has the effect of altering the surety's rights, unless the alteration is unsubstantial and not prejudicial to the surety. The rule does not permit the courts to enquire into the effect of the alteration. The consequence is that, to hold the surety to its bargain, the creditor must show that the nature of the alteration can be beneficial to the surety only or that by its nature it cannot in any circumstances increase the surety's risk."[126]

Thus, the question of whether a variation is material is answered objectively, without reference to what the parties thought. A surety may be discharged, therefore, if the variation is potentially prejudicial when made, even though it ultimately has little effect on the surety's risk.[127] Accordingly, whenever a creditor seeks a variation in the terms of his contract with the principal without the

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[123] *Polak v Everett* (1876) L.R. 1 Q.B.D. 669. *Bank of Montreal v Wilder* [1986] 8 B.C.L.R. (2d) 282 at 293 per Wilson J.

[124] *Egbert v National Crown Bank* [1918] A.C. 903, where it was held that the surety remained liable even though the creditor increased the rate of interest charged to the principal to eight per cent, the increase being illegal and ineffective: cf. *Holland-Can Mortgage Co v Hutchings* [1936] S.C.R. 165. See also *Manulife Bank of Canada v Conlin* [1996] 3 SCR 416, affirming (1994) 120, D.L.R. (4th) 234.

[125] (1878) 3 Q.B.D. at 505; *Croydon Gas Co v Dickinson* (1876) 2 C.P.D. 46, *Bank of Baroda v Patel* [1996] 1 Ll. Rep. 391 at 396. See also *Re Darwen and Pearce* [1927] 1 Ch. 176.

[126] See also *Corumo Holdings Pty Ltd v C Itoh Ltd* (1991) 5 A.C.S.R. 720, at 729 and 753. These principles were restated by Cresswell J. in *Marubeni Hong Kong & South China Ltd v Mongolia* [2004] 2 Lloyd's Rep. 198 at [206]–[209].

[127] In *Credit Suisse v Allerdale BC* [1995] 1 Lloyd's Rep. 315 Colman J. (at 365–366) applied the rule in *Holme v Brunskill* where the variation might have been, but would not inevitably have been, beneficial to the surety, in holding that the variation was material. See also *The Kalma* [1999] 2 Lloyd's Rep. 374 at 378 col. 1. This is entirely consistent with the approach of the Court of Appeal to the materiality of an alteration of the document embodying the guarantee in *Raiffeisen Zentralbank Osterreich AG v Crossseas Shipping* [2000] 1 W.L.R. 1135.

knowledge or consent of the surety, he does so at his own risk, and unless the benefit or lack of prejudice to the surety is obvious, or there is obviously no possibility of prejudice, the surety will be entitled to be discharged. It is a matter for the surety as to whether he wishes to continue to be bound by the guarantee in the circumstances of the variation of the principal contract, and if the creditor wishes to avoid the risk that the surety will seek to avoid liability under the guarantee, he should obtain the surety's prior consent to the variation.[128]

In *Lloyd's Bank TSB v Shorney* [2001] All E.R. (D) 277, a husband had given a guarantee for the liabilities of a company of up to £150,000, and he and his wife had mortgaged their home in respect of that liability. The mortgage was limited to £150,000. Clause 21 of the mortgage contained a provision which prevented the wife from enforcing any claim against her husband or the bank, or exercising any subrogation rights, until all moneys owed to the bank had been paid off. The bank then lent further sums which were covered by the husband's guarantee. He defaulted, and the bank obtained judgment against the husband for £238,000 and sought a charging order on the home for the balance. The wife paid the £150,000 and claimed to be entitled to be subrogated to the bank's charge. The Court of Appeal held that the bank was not entitled to rely on the "all moneys" nature of clause 21 in shutting the wife out of her subrogation rights, among other reasons because its conduct in increasing the husband's liability under his guarantee had materially prejudiced the wife's position as mortgagor.[129]

A startling illustration of the operation of the rule in *Holme v Brunskill* was provided by the decision of Morland J. in *Howard de Walden Estates Ltd v Pasta Place Ltd* [1995] 22 E.G. 143. There, the use provision in a lease of a delicatessen was progressively released, to permit sale of wine to customers taking meals, and off-licence use. The sureties were not parties to the variations, but when they were sued for rent after the assignee went into receivership, they successfully pleaded discharge by reason of the variations,[130] on the basis that the variations were not obviously insubstantial or beneficial.

In *Unicomp Inc v Eurodis Electron Plc* [2004] EWHC 979, Evans-Lombe J., the landlord, Fortwilliam, had let commercial premises on a long lease to a subsidiary of the claimant, who had guaranteed the payment of the rent under the lease and the due performance of the covenants in it. The guarantee contained a clause by which the claimant agreed that any "neglect or forbearance" by Fortwilliam in endeavouring to

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[128] See *National Bank of Nigeria v Awolesi* [1964] 1 W.L.R. 1311, [1965] 2 Lloyd's Rep. 389, where the bank took a guarantee over an existing overdrawn bank account, and then opened a new account on which the bank then dealt with the principal; it was held that the opening of the new account was a variation which, without the consent of the surety, discharged him. See also *Bank of New Zealand v West* [1977] 1 N.Z.L.R. 31.

[129] The Court of Appeal primarily based its reasoning on the fact that the wife had contemplated that her husband would undertake no liability greater than £150,000, and took the view that clause 16 of the mortgage, which permitted the bank to "renew vary increase or determine any advances accommodation or facilities given or to be given to the Customer or to any other person" without the husband or wife's consent did not catch the taking of further guarantees (from the husband) for those advances.

[130] See also *West Horndon Industrial Park v Phoenix Timber* [1995] 20 E.G. 137, also [1995] Conv. 289, where it is suggested that in order to avoid the harsh effects of the rule, landlords should obtain the consent of all sureties for the obligations under leases. See the detailed discussion in Ch.18, para.18-002.

obtain payment or to enforce the covenants would not release or exonerate the claimant's liability under the guarantee. The tenant went into liquidation and assigned the lease to an asssignee, who took occupation and began to pay rent. Fortwilliam did not attempt to forfeit or to take the initiative to vary the lease, but simply accepted rent from the assignee on the same terms. Evans-Lombe J. held that Fortwilliam's conduct constitited a forbearance within the meaning of the guarantee and that the claimant was not released by operation of the rule in *Holme v Brunskill*.

A variation is material so as to entitle a surety to full discharge, however, only if it is an act by the creditor which affects the risk of default by the principal, and consequently the risk of the surety being called upon to honour the guarantee. [131] Such a variation alters the basis on which the surety agreed to become liable under the guarantee, and not to release the surety in those circumstances would be to allow the creditor and the principal to impose a new bargain upon the surety. In those circumstances, the surety cannot necessarily be compensated by a reduction in the creditor's right to recover against him. An example of this is provided by *Bank of Baroda v Patel* [1996] 1 Lloyd's Rep. 391, where the bank made available a facility to the principal, guaranteed by the surety, which related to import and export transactions to be undertaken by the principal with the benefit of ECGD cover, as required by the terms of the facility. The bank operated the facility in relation to a number of foreign bill transactions without there being ECGD cover in place (as the bank knew). Potter J. held that this amounted to a variation of the terms of the facility which seriously prejudiced the surety. Although he did not spell out the reason, it is clear that the failure on the part of the bank to obtain ECGD cover increased the risk of default by the principal. The result is analogous to the result where the creditor deals with securities to the detriment of the surety's interests.[132] This type of variation must be contrasted with a variation which merely affects the amount of the surety's ultimate liability, but which leaves the risk of default by the principal unchanged; this variation will not be material.[133]

In *Davenham Trust plc v Homegold Ltd* (Manchester Mercantile Court, 22 April 2009, Judge Hegarty QC), the court had to consider whether the principle in *Holme v Brunskill* applied in the case of a guarantee containing a very wide all monies clause. The Judge noted that the application of principle by Potter J. in *Bank of Baroda v Patel* was based on a concession by counsel and that where there was a material variation to one of the subsisting facilities, it was not at all obvious that the principal debtor's liability to repay would not fall within the ambit of the guarantee. The issue has been regarded as an open one, and that the better view is that if the creditor and the principal debtor are free to conclude a new agreement on different terms which would ordinarily lie within the scope of the guarantee, then by parity of reasoning a variation of an already concluded agreement should not discharge the surety[134].

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[131] Thus the taking of increased security, which is clearly beneficial to the surety, will not discharge the guarantee.
[132] See paras 9–041 and following.
[133] See the analysis in McGuinness, *The Law of Guarantee* Ch. 10, especially at 10.25–10.30.
[134] See O'Donovan and Phillips *The Modern Contract of Guarantee* (2nd English edn, 2010), para 7-11.

In *Wittmann (UK) Ltd v Willdav Engineering SA* [2007] EWCA Civ 824 (2007) B.L.R. 509, the principal debtor renegotiated its liability to the creditor for the supply of goods to the extent that the creditor obtained the right to payment of a proportion of the purchase price from various finance companies. This involved a reduction of the principal debtor's liability to the creditor to take account of the obligations assumed by the finance companies. Whilst accepting that the guarantee provided by the surety did not extend to cover the new financing arrangements, the Court of Appeal held that the guarantee continued to apply to the residual liability of the principal debtor. As Moore-Bick L.J. stated at [28]:

> "I am satisfied that, notwithstanding the changes to the original contract brought about by the financing arrangements, Willdav remained liable under the guarantee in respect of Automold's residual liability in respect of the purchase price of the goods and I would therefore dismiss the appeal."

Scope of the rule

9–025 The rule in *Holme v Brunskill* is not confined to cases in which the surety and principal have entered into a binding agreement to vary the principal contract. The surety may also be discharged by variation of the principal's liability arising out of an exercise of a right by the creditor,[135] or by an arrangement which removes a security on which the surety is entitled to rely as against the principal.[136] In *Mayhew v Boyes* (1910) 103 L.T. 1 the surety on a composition was discharged from liability to a particular creditor where that creditor (without the knowledge or consent of the surety) obtained an agreement from the principal to be paid all the debts owing to that creditor in full.

The surety may also be discharged by any variation in the performance of the principal contract.[137] In *ST Microelectronics NV v Condor Insurance Ltd* [2006] 2 Lloyd's Rep.525, the defendant guaranteed payments of sums due under certain supply agreements, which provided for a period of credit of 55 days from the end of each month of supply. An application by the supplier for summary judgment on the guarantee was refused by Christopher Clarke J. on the basis that the guarantor had a reasonable prospect of establishing at trial that the supplier and the principal had reached a legally binding agreement under which the principal agreed to make two substantial payments earlier than it was contractually bound to, and that this variation discharged the guarantor. A debtor who was entitled to a period of credit was not bound to wait until the period had elapsed before making payment, and any voluntary payment made within that period would not involve a variation of the underlying contract. However, if the debtor undertook a binding obligation to pay early, he would no longer be free to choose whether to pay at the end of the period of credit, and the contract would be varied. A variation of the contract whereby the debtor is bound to pay earlier will discharge the guarantor, unless such an agreement is, on the facts, obviously

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[135] *Re Darwen and Pearce* [1927] 1 Ch. 176.
[136] *General Steam Navigation Co v Rolt* (1858) 6 C.B. (N.S.) 575.
[137] *Bellingham v Freer* (1837) Moo. P.C.C. 333; *General Steam Navigation Co v Rolt* (above); *Calvert v London Dock Co* (1838) 2 Keen 638; Warre v Calvert (1837) 7 Ad. & El. 143.

incapable of prejudicing him. Alternatively, even if there was no binding agreement, but the premature payments had been made in response to a threat by the supplier to breach his contract by insisting upon receiving cash with each future order, that was at least arguably a dealing with the principal in a manner at variance with the contract, the performance of which the surety had guaranteed, and sufficient to discharge the guarantor. Likewise, a surety for the redemption of an annuity or for shares in a company is discharged by any variation in the mode of redemption.[138]

However, variations to collateral arrangements that may exist outside the scope of the guaranteed contract do not affect the liability of the surety, unless those variations in some way impact on the surety's risk. In *Sanderson v Aston* (1873) L.R. Ex. 73 the guarantee was for the good conduct of the servant, whose term of employment was varied to provide for three months' instead of one month's notice. It was held that the term as to notice was not part of the servant's contract, and the variation did not materially add to the surety's risk.[139]

Further, variations which are agreed to or authorised by the surety or expressly contemplated by the principal contract[140] will not discharge the surety, and nor will those authorised within the guarantee.[141] Provided that the new terms fall within the "matrix or general ambit" of the obligation guaranteed the guarantor will continue to be bound if he has assented to them: per Buxton L.J. in *Wittmann (UK) v Willdav Engineering SA* [2007] EWCA Civ 824, (2007) B.L.R. 509 at [33]. The circumstances in which such consent may extend to a variation of the guarantee itself, and the limit to which standard form clauses containing the surety's prior consent to variations of the principal contract will protect the creditor, are discussed in detail in Ch.4, paras 4–025 and 4–026.

In *Triodos Bank NV v Dobbs* [2005] EWCA Civ 630, [2005] 2 Lloyd's Rep. 588 the question was whether a guarantee to pay moneys due "under or pursuant to" a specified loan agreement, which entitled the creditor to agree to any amendment or variation of that agreement without reference to the surety, covered sums due under subsequent agreement made between the creditor and principal debtor. The Court of Appeal approached the question as a matter of construction. Longmore L. J. stated (at [9]) that "anything rightly termed a variation or an amendment is a matter which can be agreed without reference to the guarantor." This required an analysis of each subsequent agreement to decide whether it was an amendment or variation or replacement of the original agreement. On the facts, and having completed this comparison, the Court of Appeal was unanimous in concluding that the subsequent agreements fell outside the terms of the guarantee They imposed new and different obligations which could not be said to be by way of variation

[138] *Eyre v Bartrop* (1818) 3 Madd. 221; *Polak v Everett* (1876) L.R. 1 Q.B.D. 669. Cf. *Nicholson v Burt* (1882) 10 R. 121.

[139] There is some suggestion in the speech of Pollock B that the surety would not be discharged, even though the variation was potentially prejudicial to him, if he could not show actual damage to his position. Any such rule was disapproved in *Holme v Brunskill* and does not represent the law.

[140] See, e.g. *Stewart v McKean* (1855) 10 Ex. 675, where the creditor was given a discretion as the mode of accounting between himself and the principal.

[141] *British Motor Trust Co v Hyams* (1934) 50 T.L.R. 230. This will often be a question of the correct construction of the particular guarantee.

or amendment of any obligation under or pursuant to the original loan agreement (per Carnwarth L.J. at [35]). Longmore L.J. also referred to *British Motor Trust Co v Hyams*. Whilst not questioning the correctness of the decision on its facts, adverted to the wide interpretation given by Branson J. to the power of the creditor to vary the terms of the original loan agreement with the principal debtor without discharge of the surety. He considered (at [16]) that the wide interpretation in *British Motor Trust Co* was a function of the fact that the surety in that case had the benefit of a proviso to the guarantee ensuring that she was never to be liable for a sum greater than she would have been if the guarantee had been in its un-amended form. As Longmore L.J. stated at [16], "The tightness of the proviso would, no doubt, be one justification for giving a wide construction to the variation provision and enabling the new arrangement to be regarded as a variation of the old one." There is further discussion of this case in Ch.4, para.4–026.

Plainly, where the surety plays a part in the variation transaction, he will not be discharged, for example where he prepares his own documents,[142] or where he allows the creditor to think that he has consented.[143] However, the surety is not bound to enquire as to whether a variation is to take place, nor is he bound to warn the creditor against carrying it out because of some prejudice he may suffer.[144] In *Credit Suisse v Allerdale BC* [1995] 1 Lloyd's Rep. 315, the distinction was drawn between mere knowledge of the proposed variation on the part of the surety, and his consent to it (at 361–362) echoing the remarks of Blackburn J. in *Polak v Everett* (1876) L.R. 1 Q.B.D. 669 at 673. It follows that the consent of the surety must probably be communicated to the creditor in order to be effective: see *Witmann UK Ltd v Willdav Engineering SA* (above) at [27].

There is a distinction, so far as the application of the rule is concerned, between a guarantee of a specific contract and a future course of dealing, so that it will be open to the creditor, without discharging the surety, to vary the terms applicable to the future course of dealing so long as it remains within the scope of the guarantee.[145]

Where the surety gives his consent to the variation, that is sufficient to continue to bind him to the guarantee even in the absence of fresh consideration.[146] There is authority that "principal debtor" clauses in guarantees are effective to preclude the surety from being discharged in the event of a variation to the principal

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[142] *Woodcock v Oxford & Worcester Ry* (1853) 1 Drew. 521.

[143] *Hollier v Eyre* (1840) 9 C. & F. 52, followed by Beatson J. in *Meritz Fire & Marine Insurance Co v Jan de Nul NV* [2010] EWHC 3262, at [87] and [88])

[144] *Polak v Everett* (1876) L.R. 1 Q.B.D. 669 at 673.

[145] *City of London v New Hampshire Insurance Co* (January 18, 1991, Phillips J.), summarised at (1991) 3 J.I.B.F.L. 144; reversed on other grounds sub nom. *Wardens and Commonalty of the Mystery of Mercers of the City of London v New Hampshire Insurance Co Ltd* [1992] 1 W.L.R. 792.

[146] *Mayhew v Crickett* (1918) 2 Swanst. 185, per Lord Eldon L.C.; *Smith v Winter* (1834) 4 M. & W. 454; *Phillips v Foxall* (1872) L.R. 7 Q.B. 666 at 676–677. The basis for this rule is that consideration is not necessary since the consent simply revives an old obligation rather than creates a new one. This is a peculiar application of the doctrine of consideration, but the rule (perhaps to be limited to principal and surety cases) is now enshrined in the law, and can be explained, it is suggested, on the basis that the surety would be estopped from objecting to the variation, the other parties having relied on his consent in going ahead. See *Credit Suisse v Allerdale BC* [1995] 1 Lloyd's Rep. 315

contract.[147] However, "principal debtor" clauses have been scrutinised carefully by the courts, and rarely provide the protection the creditor seeks.[148]

Acceptance or ratification by the creditor of conduct that amounts to a repudiatory breach of the principal contract by the principal does not discharge the surety,[149] and nor do any changes in the relationship between the creditor and the surety which alter their relationship in a way which does not impact upon the surety's risk. While novation of the principal contract will discharge the surety,[150] a mere assignment by the creditor of his rights thereunder will not.[151] A failure of the creditor to exercise a legal right which he has against the principal, or a simple omission, does not amount to a variation of the principal contract sufficient to discharge the surety.[152] When the surety is discharged, he is entitled to be released from any security which he has given in respect of the guaranteed obligation.[153]

Exceptions to the rule

The rule in *Holme v Brunskill* will not apply notwithstanding that the surety is prejudiced by the variation in two circumstances as described below. **9–026**

(1) Unenforceability of the variation

Where the variation is unenforceable on the grounds of illegality, the surety will not be discharged. In *Egbert v National Crown Bank* [1918] A.C. 903 the variation of the interest rate from 7 per cent to 8 per cent was illegal, and so the surety remained liable on the guarantee to the bank. Further, where the variation is obtained by fraud of the principal, the surety is not entitled to be discharged.[154] **9–027**

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147 *General Produce Co Ltd v United Bank* [1979] 2 Lloyd's Rep. 255; *Byblos Bank SAL v Al-Khudhairy* [1987] B.C.L.C. 232. In *Marubeni Hong Kong & South China Ltd v Mongolia* [2004] 2 Lloyd's Rep. 198, Cresswell J. analysed whether the liability assumed by the defendant surety was as primary obligor or not and concluded that it was not. However, he said (at [142]) that even if the defendant had undertaken a primary liability, it did not follow that the rule in *Holme v Brunskill* had no application. However, he appears to have based himself on the terms of the documents in that case rather than any authority in support of that proposition. On appeal, the Court of Appeal upheld the judge's characterisation of the contract as a guarantee. They expressed no view on his alternative approach [2005] 2 Lloyd's Rep. 231.

148 In both *Manulife Bank of Canada v Conlin* (1996) and *Credit Suisse v Allerdale BC* [1995] 1 Lloyd's Rep. 315, principal debtor clauses failed to prevent variations from discharging the sureties. See further, McGuinness (2nd edn, 1996) at paras 7.37-7.38.

149 *Moschi v Lep Air Services* [1973] A.C. 331.

150 *Commercial Bank of Tasmania v Jones* [1893] A.C. 313.

151 *Bradford Old Bank Ltd v Sutcliffe* [1918] 2 K.B. 833, per Pickford L.J. at 841; *Wheatley v Bastow* (1855) 7 De M. & G. 261 at 279. See *First National Corpn v Goodman* [1983] B.C.L.C. 203 at 210 ; followed in *Walker Crips Stockbrokers v Savill* [2007] EWHC 2598

152 *Kingston Upon Hull Corp v Harding* [1892] 2 Q.B. 494. Thus is not the case where the omission relates to something which the creditor has contracted with the surety to do.

153 *Bolton v Salmon* [1891] 2 Ch. 48; *Smith v Wood* [1929] 1 Ch. 14.

154 *Bramley Union Guardians v Guarantee Society* (1900) 64 J.P. 308. It is not clear what the position would be where the variation is obtained by the fraud of the creditor. It is submitted that the surety would be entitled to his discharge, since the creditor could not plead his own fraud in making a claim against the surety.

Chapter 13

Insolvency

The insolvency of the principal

When the principal becomes insolvent, a number of matters may arise for consideration, such as whether payments to the creditor made by the principal which would normally discharge the surety are impugnable by the liquidator or trustee-in-bankruptcy as preferences,[1] or as transfers at an undervalue, or whether security given by the principal during the period prior to insolvency can be avoided. These questions raise issues of general insolvency law applicable not only to guarantee cases but to all commercial relationships, and are therefore outside the scope of this work.[2] The main area of concern in the context of contracts of suretyship is the question of whether and in what circumstances the surety has a right of proof in the insolvency of the principal for his indemnity. **13–001**

The rule against double proof

The general rule

The respective rights of the creditor and the surety to prove in the insolvency of the principal are governed by the rule against double proof. The essence of this rule is that the insolvent estate should not be compelled to entertain more than one proof in respect of the same debt, for to do so would unfairly distort the pari passu principle of distribution in insolvency. It prevents two creditors from proving in the insolvency of the principal in respect of what is in effect the same debt, so that there is no doubling-up of dividends.[3] **13–002**

The rule was recently described in pithy terms as follows:

> "This is the rule under which, where a debtor is subject to insolvency proceedings, if a creditor proves in those proceedings for the debt, a guarantor of the debt, though in principle entitled to a right of contribution against the debtor to the extent that he has paid the creditor, is not allowed to prove against the debtor unless and until he has paid the creditor in full. He cannot

[1] See Ch.9, para.9–002 and fn.10.

[2] For a useful review of the problems that arise in guarantee cases where the principal is insolvent, see *Goode on Legal Problems of Credit and Security*, (4th edn, 2008), paras 8.16–8.34.

[3] See *Re Oriental Commercial Bank* (1871) L.R. 7 Ch. App. 99; *Re Moss Ex p. Hallett* [1905] 2 K.B. 307; *Re Fenton Ex p. Fenton Textile Association Ltd (No.1)* [1931] 1 Ch. 85; *Barclays Bank Ltd v TOSG Trust Fund Ltd* [1984] 1 All E.R. 628, CA; *Stotter v Equiticorp Australia Ltd* [2002] 2 N.Z.L.R. 686 at [48], and the comprehensive review of the authorities by Lord Walker in The matter of *Kaupthing Singer and Friedlander Ltd (in administration)* [2011] UKSC 48 (judgment handed down on October 19, 2011).

to the letter, but making no mention of the Italian proceedings which were already on foot. Some years later, having obtained judgment in Italy against the owners (who did not appear to contest the proceedings), the claimants' Italian lawyers wrote again to the Club enclosing a copy of the judgment and demanding payment under the LOU. The Club defended the claim on a number of bases, chief among which was the contention that it was an implied term of the LOU that the owners should have been given adequate notice of the Italian proceedings and that any judgment obtained by the claimants would be properly obtained and on proper notice to the Club. The Club also alleged that the deliberate failure by the claimants to inform it of the existence of the proceedings constituted sharp practice. The judge, Judge Mackie QC, whilst deprecating the behaviour of the claimants' Italian lawyers (he said that if the litigation had been conducted in London he would have placed it "towards the bottom of the range of acceptable conduct") was not prepared to imply the terms contended for. He said it was not obvious to the parties to the LOU that it was intended that notice would be given to the Club or its lawyers of proceedings being taken against the owners, although if the LOU had contained a nomination of lawyers provision, the position might well have been different. As for sharp practice, he rightly held that this did not give rise to any independent defence to a claim on a guarantee. Thus a P&I Club which wishes to keep an eye on foreign proceedings which could lead to a claim on a guarantee would be well-advised to make specific provision in the guarantee obliging the beneficiary to keep it informed of any proceedings against its members which could give rise to a claim on the guarantee in due course.

The situation often occurs in which the vessel arrested or threatened with arrest is chartered. In such a case, the cargo claimant may have claims against both owner and charterer, or the owner may have a claim against the charterer for an indemnity or contribution in respect of the cargo claim. If the owner and charterer are entered in the same P&I Club, problems are unlikely to arise. However when they are entered in different clubs it is important for the owners, or their Club, to ensure that any corresponding security which is obtained from the charterers' Club is couched in appropriate terms and, in particular, that there is an adequate mechanism for dispute resolution.

The case of *Newcastle Protection and Indemnity Association Ltd v Assurance Foreningen Gard Gjensidig* [1998] 2 Lloyd's Rep. 387 provides an illustration of the kind of problems which might arise in this situation. A cargo claim was made in respect of some fishmeal which had overheated and caught fire while it was being discharged. Damage was caused by the fire and the seawater which was used to extinguish it. The cargo receivers threatened to arrest the vessel and demanded security in excess of US$1 million from the owners and charterers. The owners' Club, Newcastle, put up a guarantee on behalf of the owners. After further discussion it agreed with the charterers' Club, Gard, that the guarantee would be extended to cover charterers' liability on condition that Gard provided counter-security. Gard provided a letter of guarantee agreeing to indemnify Newcastle in respect of all sums payable under the terms of its guarantee which were agreed or found "in accordance with the arbitration clause contained in the charter party" to be the direct and sole liability of the charterers. The letter required Newcastle to inform Gard immediately of any proposed terms of settlement of the cargo claim.

Precedent 13

Indemnity for the Fidelity of an Employee

THIS AGREEMENT is made this 1st day of December 1992 BETWEEN: **P13–001**

The COUNTESS OLIVIA of GRIEF of Willow Mansion, Love Lane, Illyria (herein referred to as 'the Employer')

and

SIR TOBIAS BELCH also of Willow Mansion, Love Lane, Illyria and SIR ANDREW AGUECHEEK lately of Castle Adamant, Arden and temporarily of The Plough Inn, Illyria (herein referred to as 'the Sureties')

In consideration of the Employer having at our request agreed to employ one MALVOLIO PROUD ('the Employee') in the office of Steward with effect from 7 December 1992, we the Sureties hereby jointly and severally agree as follows:

(1) The Sureties hereby undertake that they will be answerable to the Employer for the honest, due and faithful fulfilment by the Employee of such duties as the Employer may reasonably call upon and require him to perform in connection with the said office, and for his faithful and honest conduct during his service in that office, for so long as he shall be in her service and employed by her in that office, and in particular (without prejudice to the generality of the foregoing) that he will:

(a) timeously and satisfactorily account for and pay over and deliver to the Employer all monies and securities for money, goods and other property whatsoever which the Employee shall receive for the use of the Employer or which shall at any time or times be entrusted to the care of the Employee by the Employer or by any other persons to whom the Employer is or may be liable or accountable therefor; and

(b) not steal, embezzle, or otherwise convert to his own use any monies or other property of whatsoever nature of the Employer or of any other persons to whom the Employer is or may be liable or accountable for the safe custody or keeping of the said property.

(2) Without prejudice to Clause 1 above, the Sureties each agree to indemnify the Employer against all loss damage costs and expenses of whatsoever nature which she may incur or sustain by reason of any misconduct (whether criminal or otherwise) or dishonesty or negligence on the part of the Employee during the course of his employment in that office or by reason of any failure by the Employee duly to fulfil and perform the duties required of him in connection with that office.

(3) The maximum liability of each of the Sureties individually and the total amount recoverable from both of the Sureties together under Clauses 1 and 2 above in respect of all defaults of the Employee shall not exceed £1,000 and shall not exceed £250 in respect of any one act or omission.[1] Subject to these limits, the Sureties shall be liable to indemnify the Employer in respect of all sums which she may lose and all loss and damage which she may sustain by reason of any act, omission or default of the

Employee in the course of his employment in the office aforesaid, and not merely those amounts for which the Employee might be liable to the Employer.

(4) The agreements liabilities and obligations on behalf of the Sureties contained herein shall take effect as joint and several agreements, liabilities and obligations and neither of the Sureties shall be released from liability hereunder by reason of this Indemnity not binding or ceasing for any reason to bind the other of them (whether by agreement with the Employer or otherwise).

(5) This Indemnity shall be a continuing contract and shall remain in operation until the dismissal of the Employee from the office or until his contract of employment has otherwise terminated or until the Sureties have received notice in writing of his death in service, provided that:

(a) each of the Sureties shall be at liberty to give to the Employer one month's written notice of revocation of this Indemnity with respect to his future liabilities hereunder;
(b) the obligations of the Sureties under Clauses 1 and 2 herein and this Indemnity shall continue in effect after termination of the contract of employment or the death of the Employee or the time at which any notice of revocation of this Indemnity takes effect, and the Sureties shall remain liable in respect of all acts omissions defaults or liabilities which have occurred or arisen prior to such termination, death or revocation.

(6) The Sureties hereby acknowledge and accept that their liabilities and obligations hereunder are undertaken as principal obligors and shall not be diminished, prejudiced, impaired or discharged by reason of any dealings between the Employer and Employee of whatsoever nature or treated as co-extensive with any liabilities of the Employee to the Employer.

Signed
Sir Tobias Belch, Knight Sir Andrew Aguecheek, Knight

In the presence of

Maria Scullion
(Occupation) Lady's Maid
At Willow Mansion, Love Lane, Illyria

Note

P13–002 [1] This is intended to stop one of the sureties from arguing that if the limit is £100, he is only liable for £50, and to stop the employer from arguing that he is entitled to recover £100 from each surety.